

STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition	:	
of	:	
MARK AND HELEN DICKINSON	:	DETERMINATION
	:	DTA NO. 815986
for Redetermination of a Deficiency or for Refund of	:	
Personal Income Tax under Article 22 of the Tax Law	:	
for the Years 1992 and 1993.	:	

Petitioners, Mark and Helen Dickinson, 112-114 West Main Street, Batavia, New York 14020, filed a petition for redetermination of a deficiency or for refund of personal income tax under Article 22 of the Tax Law for the years 1992 and 1993.

A hearing was held before Roberta Moseley Nero, Administrative Law Judge, at the offices of the Division of Tax Appeals, 77 Broadway, Buffalo, New York, on August 19, 1998 at 10:15 A.M. Petitioners' reply brief was received on December 16, 1998, which date began the six-month period for the issuance of this determination. Petitioners appeared by Gary M. Kanaley, Esq. The Division of Taxation appeared by Terrence M. Boyle, Esq. (James Della Porta, Esq., of counsel).

ISSUES

I. Whether the Division of Taxation may use indirect audit methods in a personal income tax audit without first ascertaining the inadequacy or incompleteness of the books and records maintained by the taxpayer.

II. Whether petitioners have established that the Division of Taxation did not follow its own audit guidelines by failing to utilize a pure source and applications of funds analysis, or by

failing to inquire as to any accumulated cash that existed at the beginning of the audit period, and, if so, what the effects are of such failures on the notice of deficiency.

III. Whether petitioners have proven the existence of additional available cash during the audit period (in the form of accumulated cash available at the beginning of the audit period or proceeds from a bank account closed during the audit period), the amount of such cash or the uses to which such cash was put during the audit period.

PROPOSED FINDINGS OF FACT

Pursuant to section 307(1) of the State Administrative Procedure Act and section 3000.15(d)(6) of the Tax Appeals Tribunal Rules of Practice and Procedure, the Division of Taxation submitted 30 proposed findings of fact which have been substantially incorporated into the Findings of Fact. They have been supplemented by additional facts to more accurately reflect the record. Where a proposed finding of fact or partial proposed finding of fact has been rejected it is specifically noted.

Petitioners objected to 10 of the proposed findings of fact submitted by the Division (numbers 4, 6, 10, 12 [footnote 11], 13, 16, 24, 27, 28 [including footnote 17], and 29). Where the substance of petitioners' comments have not been included, it has been specifically noted.

FINDINGS OF FACT

1. An audit conducted by the Division of Taxation ("Division") of petitioners' personal income tax liability for the years 1992 and 1993 resulted in a determination by the Division that petitioners had underreported their taxable income by \$92,752.28 for 1992 and \$40,143.30 for

1993.¹ Additional tax found due was \$6,786.92 and \$1,810.95 for the years 1992 and 1993, respectively.²

2. On May 5, 1997 the Division issued a Notice of Deficiency to petitioners asserting tax due in the amounts of \$6,786.92 and \$1,810.95 for the years 1992 and 1993, respectively. Negligence penalty under Tax Law § 685(b) was also asserted.

3. At the hearing in this matter, the Division presented the testimony of Michael VanWagnen, Tax Auditor II. Mr. VanWagnen was the supervisor of the auditor who actually conducted the income tax audit of petitioners, Ms. Amy Valtin (“auditor”). The auditor was not available to testify at the hearing on August 19, 1998 because she was on maternity leave which had commenced on July 31, 1998. The Division did submit an affidavit which had been signed by the auditor on July 28, 1998.

4. Testimony presented at the hearing in this matter on behalf of petitioners consisted of the testimony of Mr. Edward R. Turner, Sr., petitioners’ accountant and Mr. Mark Dickinson, one of the petitioners herein. Ms. Helen Dickinson, the other petitioner, did not appear or testify at the hearing.

5. Petitioners owned and operated a gas station and motor vehicle repair shop located in Batavia, New York during the years at issue. Towing services were also provided as part of the business. Petitioners owned eight tow trucks during 1996, the year when the majority of the

¹This determination was based upon a source and application of funds audit and a review of petitioners’ rental income records. There were also Federal Schedule A adjustments which are not at issue in the present matter.

²Petitioners’ rental income and expenses were computed in determining taxable income. Net rental income was a separate item of adjustment as outlined on the Statement of Audit Adjustment, even though it had been included as a source of funds for the years at issue, because it was a taxable unreported source of funds.

audit took place.³ Petitioners had during the years in question a service contract with the American Automobile Association (“AAA”) which required Mr. Dickinson to be on call seven days a week.

6. Mark Dickinson had left home at the age of 16 due to family difficulties. At that time he began working for a Mr. Parise, pumping gas at the service station which he eventually purchased. Mr. Dickinson continued to work pumping gas part-time until he graduated from high school. At that time, AAA approached Mr. Parise to become an AAA garage. Mr. Parise did not own a tow truck, so he purchased a tow truck to be able to fulfill the AAA requirements. Being affiliated with AAA also meant that the truck had to be available 24 hours a day and so Mr. Parise provided lodging for Mr. Dickinson in his rental property, located in close proximity to the garage, so that he was available to take these calls.

Mr. Dickinson was saving money in order to have a down payment with which he could purchase the business from Mr. Parise who was expecting to retire in several years. Mr. Parise had offered to finance the sale if Mr. Dickinson had the down payment. Mr. Dickinson listened to the advice of Mr. Parise in money matters. Mr. Parise instructed him to put \$2,000.00 a year in an IRA which he did.⁴ Mr. Dickinson testified that he also saved money by keeping cash in a safe at the garage, as had been done by Mr. Parise. Mr. Dickinson explained that upon leaving home at the age of 16, his family took what money he had saved in a bank account, amounting to several thousand dollars and that “I was reluctant to put anything anywhere anyone could get their hands on it, besides Mr. Parise and myself” (Tr., p.122).

³The business currently owns 13 tow trucks.

⁴At the time Mr. Dickinson closed out his IRA account, which was in a mutual fund, in 1997, there was approximately \$69,000.00 in the account.

Petitioners were married in 1985. In 1986, petitioners purchased the business from Mr. Parise, Helen Dickinson's father, for approximately \$360,000.00 payable over 15 years with a down payment of \$20,000.00. Mr. Dickinson was approximately 23 years old at the time and was working full time at the business. Helen Dickinson worked at Marine Midland bank at the time petitioners were married and retained that position for three or four years prior to working full time for the business.

7. In 1995,⁵ the auditor commenced a field audit of petitioners' New York State personal income tax returns filed for the years at issue. The auditor determined that there were several indications that the income as reported by petitioners on their tax returns for the years at issue and in the books and records provided to the Division did not accurately reflect petitioners' income.⁶

The auditor determined that the amount of interest income reported by petitioners (\$9,524.00 and \$8,432.00 for 1992 and 1993, respectively) was abnormally high in comparison to the overall income reported for the tax years, (\$9,480.00 and \$12,244.00 for 1992 and 1993, respectively). The auditor also observed that the cost of assets purchased without financing during the years at issue was abnormally high in comparison to the income reported on the income tax returns.

8. During the years at issue petitioners also owned rental property located in Batavia. Petitioners did not file a Federal Schedule E in regard to the rental income generated by the

⁵The Division's proposed findings state that the audit began in 1996. However, the audit report and the affidavit of the auditor clearly indicate that the audit began in 1995 and continued on into 1996.

⁶The Division's request for a finding of fact that the auditor found petitioners' records "poor" based on one general sentence in the auditor's affidavit is rejected. Instead the specific findings made by the auditor regarding petitioners' records have been included to more accurately reflect the record.

property or otherwise report the rental income on their Federal or State income tax returns filed for the years at issue. The auditor became aware of this failure to report rental income on February 2, 1996 when informed of this by petitioners' accountant, Mr. Turner. Specifically the Tax Field Audit Record states in the February 2, 1996 entry "The rep. indicated that he forgot to file a Schedule E for both years as the t/p's have rental property and received rental income." The fact that petitioners owed additional tax for the audit period for the rental income is not at issue in these proceedings and was conceded by Mr. Turner during the audit.⁷

9. In part because of the inconsistencies found in regard to petitioners' finances, the auditor conducted a source and application of funds audit to verify the accuracy of income reported on petitioners' returns for the years at issue and, implicitly, the accuracy of petitioners' records.

10. The auditor had received formal training in conducting a source and application of funds audit before the audit in question was performed. She was also familiar with the Division's written audit guidelines regarding the performance of indirect audits, including source and application of funds audits.⁸

11. Mr. VanWagnen, the auditor's supervisor testified that the purpose of a source and application of funds audit is to verify the funds available to a taxpayer over a year in relation to the amount of the expenditures incurred by the taxpayer during the year. In essence, the method is a device to reconstruct income and expenses for a tax period. The theory behind the audit

⁷The Division asserts that Mr. Turner's testimony on this point was not believable, pointing out Mr. Turner's familiarity with petitioners' business and the fact that the mistake occurred two years in a row, among other factors. However, Mr. Turner's testimony is bolstered by the consistent statement he made to the auditor approximately two and one-half years prior to the hearing and I find his testimony on this point to be credible.

⁸The Division's request for a finding of fact that the auditor followed the audit guidelines in conducting this audit is rejected as not supported by the record (*see*, Finding of Facts "14" through "16").

method is that a taxpayer should be able to account for funds available either through expenditures, savings or asset acquisitions. That is, each application of funds should have a source that can be identified.

12. Mr. VanWagnen further testified that sources of funds are monies available to a taxpayer from any source, i.e., including nontaxable sources. The auditor found that petitioners had the following sources of funds for the years at issue: (a) interest income reported on their personal income tax returns; (b) the schedule C income reported on their tax returns; (c) the beginning balances for petitioners' bank accounts at Marine Midland bank; (d) loan repayments made to petitioners during the years at issue; (e) beginning inventory for the business; (f) depreciation expense;⁹ and (g) rental income.

13. Mr. VanWagnen then explained that applications of funds are outflows of funds. That is, applications are all cash expenditures. The acquisition of property without the expenditure of funds such as the purchase of an asset that is financed would not constitute an application of funds.¹⁰ The auditor identified the following applications of funds by the Dickinsons during the years at issue: (a) ending bank balances; (b) ending inventory; (c) fixed asset purchases; (d) loan repayments by petitioners (i.e., repayments of principal); and (e) cost of living expenditures.

Cost of living expenditures were based on a cash living expense schedule prepared by the petitioners, Bureau of Labor Statistics data and an analysis of petitioners' checking accounts. Petitioners' personal checking accounts were reviewed to identify personal expenses paid by

⁹Depreciation reported on petitioners' income tax returns was included as a source of funds because it was a non cash expenditure, and, thus, skewed actual cash net income.

¹⁰Depreciation expense is not considered an application because it is not a cash expenditure.

check. The auditor used the cash living expense schedule prepared by petitioners to fix all cash living expenses except for entertainment and recreation. Because petitioners listed zero entertainment and recreational expenses on the cash living expense schedule, the auditor estimated petitioners' expenses in these areas based on what the Bureau of Labor Statistics reported would be a low amount of entertainment and recreational expenses for a family of four.¹¹

14. Included as an exhibit to the auditor's affidavit was a photocopy of the Division's audit guidelines on reconstruction of income in income tax cases ("audit guidelines"). In discussing the source and application of funds method of reconstructing income the guidelines provide: "Because this method is based on the theory that any excess of expense items (applications) over income items (sources) represents an understatement of net profit, *only the increase or decreases in assets or liabilities and other expenses and receipts are considered.*" The audit guidelines continue by contrasting this explanation of a source and application analysis with a method referred to as a Cash "T" Account analysis which "shows beginning and ending balances of assets and liabilities. Beginning balances are shown as debits; ending balances are shown as credits. An overall difference is determined by comparing beginning balances and income items with ending balances and expense items." Further explanation is given as follows:

In the source and application of funds method, rather than showing beginning and ending balances of assets and liabilities and determining an overall difference, you determine the amount of change for each asset and liability account separately.

* * *

In the source and application method, the increase in the bank balance is shown as an application (expenditure). The cash "T" method shows the beginning balance

¹¹Petitioners have contended, and indeed Mr. Dickinson testified, that they spent only small sums on entertainment and recreation, in part because of the AAA contract and his having to be "on call" 24 hours a day. However, petitioners have not at any time suggested what the proper adjustment would be and therefore, this is not an issue in the present matter and will not be discussed further.

as a debit and the ending balance as a credit, but the net result is the same.

15. A reconstruction of petitioners' income using strictly a source and application of funds method as described by the audit guidelines and the amounts utilized by the auditor in her analysis would have produced the following results for each year in issue:

1992 Sources	Amount	1992 Applications	Amount
Interest Income	\$9,524.00	Increases in Bank Balances	
Business Income	\$36,261.00	Acct. #850-83039-7 (Personal Checking)	\$21.50
Depreciation	\$47,469.00	Acct. #404000742 (Personal Savings)	\$6,166.04
Decreases in Bank Balances		Capital Asset Purchases	\$103,698.50
Acct. #858-75566-1 (Business Checking)	\$2,374.00	Ford Motor Credit Loan Payments	\$3,728.40
Acct. #851-12629-4 (Personal Checking)	\$1,827.78	Chrysler Credit Loan Payments	\$3,159.96
Acct. #858-65017-7 (Personal Savings)	\$527.63	Ford Motor Credit Loan Payments	\$6,240.00
Loan Repayment (SFM)	\$1,384.88	Mortgage Loan Payments (Business) - principal portion only	\$13,165.67
Rents Received	\$7,800.00	J. I. Case Loan Payments - principal portion only	\$8,720.28
Decrease in Inventory	\$1,220.00	Cost of Living	\$51,652.22
Total	\$108,388.29	Total	\$196,552.57

This analysis results in an excess of applications over sources of income for 1992 of \$88,164.28, the same amount determined by the auditor's analysis.

1993 Sources	Amount	1993 Applications	Amount
Interest Income	\$8,432.00	Increases in Bank Balances	
Business Income	\$3,029.00	Acct. #858-75566-1 (Business Checking)	\$7,085.08
Depreciation	\$52,475.00	Acct. #858-65017-7 (Personal Savings)	\$10,901.45
Decreases in Bank Balances		Capital Asset Purchases	\$48,770.00
Acct. #850-83039-7 (Personal Checking)	\$1,689.23	Ford Motor Credit Loan Payments	\$3,728.40
Acct. #851-12629-4 (Personal Checking)	\$8,802.70	Chrysler Credit Loan Payments	\$3,159.96
Acct. #404000742 (Personal Savings)	\$4,948.76	Ford Motor Credit Loan Payments	\$6,240.00

1993 Sources	Amount	1993 Applications	Amount
Redemption of Life Insurance Policies	\$19,220.00	Mortgage Loan Payments (Business) - principal portion only	\$14,911.38
Loan Repayment (SFM)	\$1,607.88	J. I. Case Loan Payments - principal portion only	\$7,993.59
Rents Received	\$3,800.00	Marine Midland Loan Payments	\$7,111.00
Loan Received (Marine Midland)	\$20,000.00	Cost of Living	\$53,188.01
Decrease in Inventory	\$1,249.00		
Total	\$125,253.57	Total	\$163,088.87

This analysis results in an excess of applications over sources of income for 1993 of \$37,835.30, the same amount determined by the auditor's analysis.

16. Included in the audit workpapers submitted in this matter are two one-page documents, one page for each year, entitled "SOURCE AND APPLICATION OF FUNDS ANALYSIS." This analysis, prepared by the auditor, differs on several points from the source and application of funds analysis set forth in Finding of Fact "15". First, rather than setting forth decreases in individual bank accounts as a source of income and increases in individual bank accounts as an application of income, the auditor listed the beginning balances of each bank account as a source and the ending balance of each bank account as an application. Second, rather than listing the decrease in inventory each year as a source of income, the auditor listed the beginning inventory as a source and the ending inventory as an application of funds for each year. However, the calculations as set forth by the auditor and the above calculations result in the same amount of excess applications: \$88,164.28 for 1992 and \$37,835.30 for 1993.

17. On audit the Division identified the following bank accounts: Acct. #858-75566-1 (Business Checking); Acct. #850-83039-7 (Personal Checking); Acct. #851-12629-4 (Personal Checking); Acct. #858-65017-7 (Personal Savings); and Acct. #404000742 (Personal Savings).

According to a sheet contained in the audit report entitled "Lockport Savings Bank," an analysis of 1992 deposits to Acct. #404000742 shows that on August 18, 1992 \$15,000.00 was transferred from a personal checking account into this personal savings account. On the day before, August 17, 1992, the balance in this account was zero. There were no bank statements for this account available to the auditor prior to August 17, 1992. There were no deposits to this account in 1993. This account was in the name of Helen Dickinson only.

18. Mr. Dickinson testified that not all of petitioners' bank accounts were considered in the audit in that a Lockport bank account in his wife's name had not been considered. He further testified that there was approximately \$20,000.00 in that account and that documentary evidence would support a finding that sometime in 1992 approximately \$19,000.00 was withdrawn from this account. He testified that he did not recall the account's being closed out, only that most of the funds were removed from the account. Mr. Dickinson was asked if documentation existed regarding the withdrawal of money from this account. He stated that such documentation existed but that he did not have it with him at the hearing. Petitioner did not provide any such documentation prior to the close of the hearing, or ask for additional time to present such documentation.

19. The audit guidelines provide that:

It is important in using the source and application method, as well as in using any other method, that you get information about cash hoarded and non-taxable sources early in the examination. Otherwise the taxpayer may attempt to explain an understatement by claiming that accumulated cash from prior periods was spent during the years in question.

The auditor first met with Mr. Turner, and began her review of the records provided by petitioners, on September 5, 1995. At her next meeting on October 19, 1995, the Tax Field Audit Record indicates that she had a conversation with Mr. Turner regarding the issue of a cash

hoard or accumulated cash as follows: “Discussed t/p’s cash on hand. He indicated that all of the t/p’s \$ available was what was in his accounts.” Mr. Turner was aware when he made this response that the auditor was interested in petitioners’ business and personal finances.

However, Mr. Turner testified at the hearing that his understanding of the term “cash on hand” was the equivalent of business “petty cash” as opposed to any accumulated sum of money available to petitioners at the beginning of the audit period. He also testified that at the time the question was asked he was unaware that the Division had determined to utilize a source and application of funds method to determine whether petitioners’ books and records accurately reflected their income. Mr. Turner thought that the Division was simply auditing the books and records he had provided them with and responded consistently with his understanding of the situation.

20. The results of the audit were explained to petitioners’ representative on April 19, 1996. On June 26, 1996, petitioners’ representative advised the auditor by telephone that the petitioners did not want to dispute the audit findings, but just wanted to move on. On September 18, 1996, Mr. Turner advised the auditor for the first time that petitioners allegedly had a cash hoard of \$98,000.00, \$88,000.00 of which was spent in 1992. The representative, however, could not explain specifically how this sum was used by petitioners. On December 20, 1996, Mr. Turner mailed a letter to the auditor in which he stated a source and application of funds audit “is an exceptable [sic] method by the State and tax practioners [sic] even though there may be other variations not accounted for in the process.” He also admitted in the letter that “in previous discussions, I stated that I could not see any problem with your rationale or procedure.” In support of petitioners’ claim that they had a cash hoard at the beginning of the audit years, as an attachment to the December 20, 1996 letter, Mr. Turner submitted to the

auditor a rudimentary source and application of funds analysis of petitioners' finances for the years 1986 through 1991.¹²

When the above communications between the Division and Mr. Turner are considered with his testimony at hearing, it is clear that what Mr. Turner intended to communicate to the Division was that while he understood the audit methodology utilized by the Division, based upon his knowledge of petitioners' business it was not possible for petitioners' business to have generated an additional \$88,000.00 in income in 1992, and that there must be some other explanation, i.e., there must have been accumulated cash available at the beginning of the period.¹³

21. At a February 14, 1997 meeting, the auditor was informed by Mr. Kanaley, petitioners' new and current representative, that the cash hoard was kept by petitioners in a box in their residence. At hearing, Mr. Dickinson testified that the cash hoard was kept in a safe located in his business premises.¹⁴

22. At no time during the audit did Mr. Turner or Mr. Kanaley explain how the cash hoard was specifically used during the years at issue.

23. The auditor did not accept petitioners' claim about the cash hoard because (1) she was never told how it was used during the years at issue, (2) she could not trace any large discrete

¹²Mr. Turner appears not to have made inquiries of petitioners about their applications for those years. It appears he simply used petitioners' income tax returns to identify applications. No adjustments were made for beginning and ending inventory or beginning and ending bank balances.

¹³Therefore, the Division's request for a finding of fact that Mr. Turner originally asserted the existence of accumulated cash prior to consulting with petitioners is rejected as irrelevant.

¹⁴Petitioners' objection to the Division's proposed finding of fact on the basis that Mr. Kanaley's mistake in identifying the location of the accumulated cash should not be utilized against petitioners to disprove the existence of the cash accumulation, goes to the weight to be assigned to this evidence. The fact itself is supported by the record and relevant to the Division's case.

sums of cash coming into petitioners' bank accounts during the years at issue, and (3) she could not trace the cash hoard being used for the purchase of a specific asset or other purpose. Almost all the applications and all large dollar applications identified by the auditor for the years at issue were made by check. None of petitioners' bank account statements record any unusually large deposits being made during the years at issue.¹⁵

24. Mr. Dickinson testified that his net income from his business was approximately \$40,000 to \$60,000 a year. His reported Schedule C income for the years 1992 and 1993 was \$36,261 and \$3,029, respectively. However, if the noncash business expense of depreciation is added to the amounts reported as Schedule C income, the amount of petitioners' income from the business exceeds \$60,000.00 in each of the two years in question.

25. Petitioners maintained personal savings and checking accounts and a business checking account prior to and during the years at issue.

26. Mr. Dickinson had prior to and during the years at issue several outstanding loans and a mortgage payable. Interest rates on the loans were 8.25% and 9.75% per annum.

27. Mr. Dickinson did not disclose his alleged cash hoard on any loan applications. Nor did he disclose the cash hoard to his property insurance company.

28. Mr. Dickinson testified that his alleged cash hoard in the beginning of 1992 was \$22,000 to \$23,000.¹⁶ He also testified he took \$20,000 to \$25,000 from his cash hoard during 1992 to pay a contractor (Van Son), who was constructing a storage facility for Mr. Dickinson's

¹⁵Petitioners requested that this proposed finding of fact be rejected. However, the basis of the auditor's determination to not accept petitioners' claim that they had access to accumulated cash at the beginning of the audit period is relevant to reviewing the notice of determination which was in part based on this determination. (*Matter of Hemrajani*, Tax Appeals Tribunal, August 19, 1993).

¹⁶Petitioners objected to this finding on the basis that it was not supported by the record. This is simply not the case, this testimony appears on page 161 of the transcript.

business. Mr. Dickinson did not in his testimony identify the date or dates when cash was allegedly transferred from his cash hoard to his business checking account. According to his testimony, the deposits were made in even dollar amounts.

The audit lists as an application of funds petitioners' 1992 capital asset purchases in the amount of \$103,698.50. This number is equal to petitioners' new equipment purchases as set forth in their own records. With the exception of one journal entry for \$320.00, each of these expenditures is represented by a particular check from petitioners' business checking account. Any expenditures made for the building prior to 1992, were therefore, not included as an application of funds for 1992.

A comparison of the deposits made to petitioners' business checking account and expenditures made as reflected in petitioners' books for the capital expenditure accounts for 1992 (including the business checking account records), does not indicate that there were corresponding even dollar amounts being deposited into the checking account about the time the checks to the contractor were written.

29. On the question of why he would keep cash in a safe, Mr. Dickinson testified that he lived in a small community and did not wish others to know about his finances. He also testified that he had planned the purchase of the business and the expansion of the business and wanted to have cash available when needed to implement those plans without having to rely on financing. Consistent with his testimony regarding his feelings of personal privacy about his finances, was Mr. Dickinson's testimony that he did not keep any records regarding the cash stored in the safe, and that he did not disclose the cash in the safe to any lending institutions or insurance companies. Mr. Dickinson's reluctance to disclose particular information regarding his finances was evident even during his testimony at the hearing. While he attempted to answer questions to

the best of his ability, it was obvious that he was uncomfortable discussing his finances, and even perplexed by what he felt was the personal nature of the questions.

30. Any proposed findings of fact, responses thereto or other comments regarding the validity of the source and application of funds method of reconstructing income have been disregarded as irrelevant. The validity of the method has not been questioned by petitioners, only its application in the present matter. Therefore, the validity of the method is not an issue.

SUMMARY OF THE PARTIES' POSITIONS

Petitioners argue that when conducting an income tax audit the Division may not utilize indirect audit methods where the taxpayer provides the Division with complete and accurate records. In the alternative petitioners argue that the auditor failed to follow audit guidelines by failing to utilize a pure source and application of funds analysis and by failing to inquire as to any accumulated cash that existed at the beginning of the audit period. Finally, petitioners argue that the credible testimony of Mr. Dickinson establishes that petitioners did possess accumulated cash at the beginning of the audit period and that a bank account was closed during the audit period, that petitioners did utilize such cash for personal and business expenditures and that it does not matter exactly what expenditures were made with this cash.

The Division argues that when conducting an income tax audit, it may resort to an indirect method of determining a taxpayer's income without first having to determine the adequacy of the taxpayer's records, and, in any event, petitioners' records were inadequate. The Division points to petitioners' relatively high amounts of interest income and purchases of assets in comparison to their reported income for the years in question, together with their failure to report rental income, as a basis to resort to an indirect audit method. Finally the Division argues that the source and application method utilized was in itself a means of testing whether petitioners'

records adequately reflected their income. With regard to whether petitioners established the existence of accumulated cash at the commencement of the audit period, or the closure of a bank account during the audit period, or the use of that cash for specific applications identified by the auditor during the audit period, the Division asserts that petitioners have not met their burden of proof.

In reply petitioners stress that the cases relied upon by the Division to support its assertion that it need not establish the inadequacy of petitioners' records prior to resorting to an indirect audit method in an income tax case, are factually distinguishable from the present case. Petitioners note that all of those cases dealt with situations where taxpayer records were inaccurate or did not reflect the taxpayer's income, as opposed to the present case where petitioners assert that their records were complete and accurate.

CONCLUSIONS OF LAW

A. The first issue to be addressed is whether the Division may, without first ascertaining the accuracy and completeness of a taxpayer's records, resort to an indirect audit method in an income tax audit. The simple answer is yes.

[A]n initial consideration of inadequate or incomplete books and records before employing an indirect method is normally only required in sales and use tax cases where the tax is imposed upon verifiable receipts evidenced by statutorily required books and records. (*Matter of Giuliano v. Chu*, 135 AD2d 893, 521 NYS2d 883, 886, *citing Matter of Hennekens v. State Tax Commn.*, 114 AD2d 599, 494 NYS2d 208, 209; *see also, Matter of Lee*, Tax Appeals Tribunal, October 11, 1990; *Matter of Hemrajani*, Tax Appeals Tribunal, August 19, 1993.)

Petitioners argue, however, that the present case is distinguishable in that the facts in the previous cases involved certain inadequacies in the taxpayers' records, and in this case petitioners assert that their records were adequate. In an income tax situation what is required of a taxpayer is not that certain verifiable books and records be kept, but that a taxpayer's records

accurately reflect the taxpayer's income (*Matter of Giuliano v. Chu, supra; Matter of Jacobson*, 129 AD2d 880, 514 NYS2d 145, 147; *Matter of Hennekens v. State Tax Commn., supra*). The operative principal in these cases is that where the Division is not able to determine a taxpayer's income, or the records of the taxpayer do not accurately reflect the taxpayer's income, the Division may reconstruct the taxpayer's income. In this case the auditor noted that petitioners' interest income and capital asset purchases were relatively high compared to the income reported by petitioners as being generated by the business. Furthermore, upon starting the audit, the auditor learned that petitioners had rental income from both the years in question that was not reported on their Federal or State tax returns. This information was certainly enough to justify the Division in resorting to a source and applications of fund audit to, at the very least, more accurately determine if petitioners' records accurately reflected their income (*Matter of Jacobson, supra*).¹⁷ Having reconstructed petitioners' income and finding the wide disparities reflected in the notice of deficiency, it can not be said that petitioners' records accurately reflected their income (*see, Matter of Jacobson, supra*). Therefore, the use of the source and application of funds method was reasonable under these circumstances.

B. The second issue to be addressed is whether the auditor followed the audit guidelines in conducting the audit, and if not, whether the failure to follow the guidelines voids the notice of deficiency on the basis that it lacked a rational basis.

The first question presented by petitioners on this issue is whether, in the initial stages of the audit as required by the audit guidelines, the auditor inquired as to the existence of accumulated cash that would have been available to petitioners at the beginning of the audit

¹⁷It is accepted practice to reconstruct a taxpayer's income for the purpose of determining if the records provided by the taxpayer accurately reflect that income (*see, Holland v. United States*, 348 US 121, 99 L Ed 150).

period. The auditor inquired of Mr. Turner at their second meeting as to whether petitioners had any cash on hand at the beginning of the audit period and thereby specifically complied with the audit guidelines. The fact that Mr. Turner misinterpreted the question as referring to business petty cash and answered that there was no cash on hand at the beginning of the audit period, does not in any way negate the fact that the auditor asked the question.

The second question presented by petitioners on this issue is whether the auditor's analysis is a pure source and application of funds analysis. The analysis set forth in Findings of Fact "14" through "16", is a "pure" source and application of funds analysis under the audit guidelines. This is clearly not the analysis utilized by the auditor. Petitioners are correct that the auditor performed a type of "hybrid" Cash "T" and source and application analysis. Petitioners contend that this resulted in confusion and a flawed result. As noted in the audit guidelines, and as shown in Findings of Fact "14" through "16", the bottom line in using either of these analyses is the same; in the source and application analysis computations are done prior to entering items such as bank deposits and inventory, in the Cash "T" method balances are entered and the calculations then performed. Using either analysis with the numbers provided by the Division results in petitioners' applications exceeding sources by \$88,164.28 in 1992 and by \$37,835.30 in 1993. Therefore, petitioners' argument that the auditor's analysis produces a flawed result fails. Petitioners have not pointed to any particular problems caused by use of the hybrid method employed here, or to any particular examples of the confusion allegedly caused by the methodology. Therefore, petitioners have not proven that the hybrid methodology employed resulted in an unreasonable basis for the notice of deficiency.

C. The final issue is whether petitioners have shown that there was additional cash available to them during the audit period, the amount of such cash and how such cash was spent

on specific applications identified by the auditor, so that petitioners would be entitled to an adjustment in the amount of tax found due. Pursuant to Tax Law § 689(e), petitioners have the burden of proving their entitlement to any such adjustment.

The first source of funds alleged by petitioners involves the closing of the Lockport bank account. Mr. Dickinson testified that the audit report did not list all of petitioners' bank accounts and that there was one additional bank account that was in his wife's name in the Lockport Bank with a balance of approximately \$20,000.00. He further testified that \$19,000.00 was withdrawn sometime in 1992 and that he did not recall whether they actually closed the account, but that they took most of the money out. These facts indicate that the bank account being discussed was in fact listed in the audit workpapers and considered in the source and application of funds analysis. The bank account #404000742 was listed as a personal savings account in Helen Dickinson's name only and shows a deposit of \$15,000.00 on August 18, 1992, with a balance of zero on the day before. It appears Mr. Dickinson's testimony was referring to money withdrawn from this account prior to this date. However, the audit workpapers specifically note that there were no bank statements available for the time prior to August 18, 1992 and that is why no other amounts from this bank account were included in the analysis. Petitioners have had since the audit to provide bank statements or other documentation showing this particular withdrawal. Mr. Dickinson testified at the hearing that documentation of this withdrawal was available but that he did not have it with him at the hearing. Petitioners did not request additional time to submit such documentation after the hearing. Documentation consisting of bank statements should be readily available and petitioners have offered no explanation as to why no documentation was submitted. Petitioners have simply failed to meet their burden of proof on this issue (*see, Matter of Giuliano v. Chu, supra*).

The only evidence on the issue of a cash accumulation is Mr. Dickinson's testimony and the comments and analysis done by Mr. Turner which relate solely to the issue of whether such an accumulation could have existed based on prior years income. Mr. Dickinson's history, including how and by whom he was taught his saving habits, lends credence to his testimony that he accumulated money that was kept in a safe. I do not find controlling in this particular case the indicia of the nonexistence of a cash hoard pointed out by the Division, such as failure to disclose its existence to insurance companies or possible lenders. Rather, having observed Mr. Dickinson's demeanor at the hearing, which indicated that he was still uncomfortable speaking about his finances, I find failure to tell anyone about this cash regardless of the consequences lends credence to petitioners' position that the cash accumulation existed. Further support is found in Mr. Turner's analysis, which while basic tends to show the possibility of petitioners' being able to save money in prior years, and Mr. Dickinson's testimony regarding his lifestyle, which involved being on call 24 hours a day and centered around his business. Therefore, I find credible Mr. Dickinson's testimony that at the beginning of the audit period there existed an amount of cash in a safe that he used to save for major expenditures.

However, the testimony that no written records were kept of this money, that Mr. Dickinson wanted no one to know of its existence or certainly the amount of money, while lending credence to his testimony, do not lend accuracy to determining the amount of this cash accumulation or how it was spent. Mr. Dickinson testified that there was approximately \$22,000.00 or \$23,000.00 in his safe on January 1, 1992 and approximately \$3,000.00 left in the safe on December 31, 1993. Evaluating this evidence in a light most favorable to petitioners, that would leave an additional source of income for the audit period of \$20,000.00. Contrary to petitioners' assertion that how the cash was spent is irrelevant, petitioners have the burden of

proving that this \$20,000.00 can be identified in the applications found by the Division (*see, Matter of Trieu*, 222 AD2d 743, 634 NYS2d 878, *lv denied* 88 NY2d 808, 647 NYS2d 714).

Assuming petitioners have proven an additional \$20,000.00 source of income, unless that income was utilized for an application identified by the auditor, it was not counted as additional income for the audit period and is not relevant to the case.

Mr. Dickinson testified that these funds would have been utilized to pay for the building placed in service in 1992 to house the tow trucks. He testified that as payments became due to the contractor Von Son, he would have deposited funds into his business checking account from the cash available in the safe to pay these bills, and that such deposits would have been in even dollar amounts. Mr. Dickinson appeared convinced that a review of the bank records would prove this. Having reviewed the information set forth in the audit report on the bank records, and finding no deposits to the business checking account in similar amounts and within the proximate time frame that the payments were made by check to Von Son, it must be found that Mr. Dickinson's recollection on this issue is not supported by the documentary evidence. Petitioners' alternative argument that any accumulated cash would have been used for cash purchases is in direct conflict with Mr. Dickinson's testimony that the cash was spent on the garage, and therefore fails.

While I do not doubt the existence of a certain amount of accumulated cash at the beginning of the audit period, Mr. Dickinson's recollections as to the amounts and how such cash was spent are not in any way supported by the documentary evidence. Therefore, while it is understandable that Mr. Dickinson's recollections are not exact, it must be found that petitioners have failed to prove that the accumulated cash was spent on applications identified on audit. Therefore, petitioners are not entitled to any adjustment of the tax found due.

D. Negligence penalty pursuant to Tax Law § 685(b) was asserted in this matter.

Petitioners presented no arguments on the penalty issue and therefore, this issue will not be addressed.

E. The petition of Mark and Helen Dickinson is denied, and the notice of deficiency dated May 5, 1997 is sustained.

DATED: Troy, New York
May 20, 1999

/s/ Roberta Moseley Nero
ADMINISTRATIVE LAW JUDGE